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Economic Integration in the Gulf Region: Does the Future Hold More Promise than the Past?

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Interest in economic integration on the part of Gulf Cooperation Council (GCC) countries has changed considerably over time. Initially, the charter signed by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) in May 1981 was concerned primarily with strengthening the defense of the Arab Gulf region. Specifically, the main motivation behind the creation of the GCC was the threat posed to regional security by the Iran-Iraq war. Progress towards integration among the GCC states has been very slow and until fairly recently, little hope was held for forward movement in this area. Recently, however, the situation with Iraq has heightened the importance of the Union (Allen, 2003). There seems to be a growing sense among the member states that the long run economic viability and thus the security of these countries will be largely determined by their progress in reducing their heavy reliance on oil revenues. In turn, this will depend on how effectively the member countries are able to remove the many remaining hurdles in the way of setting up a customs union capable of facilitating efficient industrialization and meaningful economic diversification. An examination of the GCC's track record and of recent trends suggests that the time may at last be ripe for economic integration among the Gulf States.

Background

While economics were secondary in the formation of the GCC, the GCC Economic Agreement, passed in June 1981, did set out certain economic objectives for the fledgling organization:

- Implementing a free trade area with no barriers on regional products and common tariffs on foreign imports
- Consolidating bargaining power in negotiations with external trading partners
- Establishing a common market that grants citizens the right to travel, work, own, and inherit in all member states
- Harmonizing development plans to promote integration
- Adopting a common oil policy
- Coordinating industrial policy, particularly with respect to petroleum based products
- Promoting joint projects to coordinate chains of production
- Adopting a common legal framework for regional trade and investment
- Linking transportation networks

Economic and trade-related objectives were further specified in the United Economic Agreement (UEA) signed in November 1981. These included free trade in all agricultural products, animals, industrial products, and natural resources that originated within the member states, the introduction of a common external tariff and trade policy; and a coordination of economic development within the GCC.

December 2001 Initiatives

Since the end of the Iran-Iraq conflict in 1988, many observers sensed that the GCC had lost some of its sense of direction. Over time, many of the goals noted above were modified or sidelined because they impinge on national economic sovereignty (Dar and Presley, 2001). Still, memberstates' foreign ministers meet in a ministerial council every three months. Heads of state hold an annual summit. Typically, the summits are mostly concerned with putting on a show of unity to the outside world.

All this seems to have changed with the most recent meeting, held in December 2001. Saudi Arabia's Crown Prince Abdullah set the tone in the opening session by lamenting the limited progress made by the GCC to date: "We are not ashamed to say that we have not been able to achieve the objectives we sought when we set up the GCC 20 years ago," he said. "We have not yet set up a unified military force that deters enemies and supports friends. We have not reached a common market, or formulated a unified political position on political crisis. Objectivity and frankness require us to declare that all that has been achieved is too little and it reminds us of the bigger part that has yet to be accomplished… We are still moving at a slow pace that does not conform with the modern one." And finally: "Our too great attachment to the traditional concept of sovereignty is the biggest stumbling block hindering unification efforts."

These statements are certainly borne out by the data. After 20 years of operation, the share of intra-regional trade in the GCC has only increased from about five percent in 1982 to a little over seven percent by 2000. Typically, regional trading groups show intra-regional trade above 30 percent of total trade; in the case of the European Union (EU), it now exceeds 55 percent.

Apparently sharing his concern, the member states voted to bring forward their plans for a GCC customs union. Specifically, their agreement entailed unifying customs tariffs at 5 percent by 2003. In a significant step, it was also agreed to introduce a single GCC currency by 2010.

The decision on unifying customs tariffs at the 5 percent rate represents a speeding up of the process approved at the previous GCC annual summits. Meeting in Riyadh in 1999, the GCC leaders had agreed to postpone the introduction of common tariffs until 2005, a decision they confirmed in Bahrain at the end of 2000, when a proposal to bring the tarriff reduction forward to 2003 was rejected. In effect, this tariff unification finally implements the initial economic integration agreement between the GCC members. Given the 20 or so years to reach this first step toward a customs union, the 2003 deadline facing the member countries is truly daunting.

The GCC heads of state also agreed in principle that Yemen should eventually be allowed to accede to the organization. Actual Yemeni membership on the key GCC institutions remains very far away however. The idea has only become conceivable since Saudi Arabia and Yemen resolved their border dispute in 2000, and, for the time being, Yemen will only join GCC bodies involved with health, education, and labor and social affairs.

Finally, the members agreed to create a monetary union. This is to occur in three steps: pegging all national currencies to the dollar within a year, drawing up a legislative framework by 2005, and the launch of a joint currency in 2010. Clearly based on the EU experience, this also presents a daunting task for the member countries.

Trade Patterns With Integration

Progress towards increasing trade between the GCC states has generally been limited with several distinct patterns emerging (See Table 1 and Table 2).

Bahrain

Bahrain actually experienced rapid increases in imports and exports in the pre-Union period. However, in the post-Union period the country has had negative growth in both imports and exports to the GCC countries. Because the country experienced healthy increases in overall imports and exports, the share of imports from the GCC countries fell dramatically—from 52.74 in the pre-Union period to 37.47 percent by 1993-2001. Similarly, exports to the GCC countries fell from 27.16 percent in the pre-Union period to 7.58 during 1993-2001. Of the GCC countries, Bahrain's shift towards increasing imports from the Industrial countries and away from the GCC is unique (Figure 1).

Oman

In contrast to Bahrain, Oman has had a considerable expansion in its trade with the GCC. In both the pre- and post-Union years, Oman's trade with the GCC has increased at a rate considerably above that recorded for overall imports and exports. As a result, there has been a marked percentage increase in the country's share of trade accounted for by the GCC, with exports to the GCC increasing from 0.27 percent of total to 11.68 percent by the 1990s. Most of this export growth, however, took place in the 1990s (Figure 2). In contrast, the share of imports from the GCC countries began increasing shortly after the Union, increasing from 20.82 pre-Union to 31.25 percent in the 1990s.

Kuwait

Kuwait presents a different trade pattern. Trade with the industrial countries has declined in importance slightly over time with import shares declining from 73.37 pre-Union to 65.42 percent in the 1990s. The corresponding figures for exports were 57.48 to 47.33 percent. Exports to the GCC countries, always small, have also declined in importance from 4.15 pre-Union to 1.56 percent in the 1990s. However, imports from the GCC have expanded relatively rapidly (Figure 3) at an average annual rate of 11.77 percent in the post-Union years. As a result, the GCC share in Kuwait's total imports increased from a negligible 0.66 percent pre-Union to 10.18 percent in the 1990s.

Qatar

Qatar's trade with the GCC has some resemblances to that of Kuwait (Figure 4). As with Kuwait, GCC trade still accounts for a relatively small share of overall imports and exports. Also as in the case of Kuwait, there has been an increased share of imports coming from the GCC states after Union (6.22 percent post-Union to 13.90 percent in the 1990s). Exports from the GCC countries, while not declining, have maintained a fairly constant share in the post-Union period (5.26 percent 1982-1992, and 5.34 percent over the 1993-2001 period).

UAE

The UAE has had a healthy expansion in trade with the GCC countries with imports and exports averaging an annual rate of growth of 10.14 and 10.63 percent respectively in the post-Union period. Ironically, these rates are lower than the corresponding 20.79 and 21.84 percent rates achieved in the pre-Union years. Because the country's overall rates of imports and exports were strong in the post-Union period, there has been only a marginal increase (Figure 5) in the shares accounted for by the GCC countries—exports increasing from 2.31 percent in the pre-Union years to 6.77 percent by the 1990s. Imports actually declined from 5.77 percent in the pre-Union period to 5.33 percent in the 1990s (after averaging 5.99 percent from 1982-1992).

Saudi Arabia

Saudi Arabia is by far the largest of the GCC countries, so its import/export patterns will go a long way in determining the overall amount of intra-group trade. Overall, Saudi trade patterns show a resemblance to those of the UAE (Figure 6 vs. Figure 5). Imports and exports with the GCC have maintained a relatively low share in overall trade, with a slight decline in the share of trade with the industrial countries. As with the UAE, Saudi Arabian trade with the GCC wile strong in the post-Union period, was actually lower than that experienced in the pre-Union days, with exports declining to 5.92 percent annual average growth (from 9.05 percent) and imports averaging 5.65 average annual growth in the post-Union period as opposed to 10.5 percent annual growth in the pre-Union years. As a result, exports to the GCC countries increased slightly from 5.23 percent in the pre-Union days to 6.9 percent in the 1990s. The corresponding figures for imports were 2.88 percent of the total in the pre-Union period to 3.1 in the 1990s. The increase in Saudi exports to the GCC countries also presents an interesting pattern with most of the increases going to the UAE (and to a lesser extent Kuwait) at the expense of Bahrain (Figure 7).

Causes of the Slow Pace

Given the current enthusiasm for economic integration, it is a bit of a mystery just why the process has proceeded so slowly. Lack of significant integration among the GCC countries is commonly attributed to their heavy reliance on oil production and export. But the success of other commodity exporters—such as Chile, Malaysia, Morocco, and Turkey—suggests that commodity production in itself does not condemn a country to low productivity and an inability to diversify. Logically, several factors may have impeded integration:

- The pursuit by key members of incompatible development strategies
- A fear on the part of several or all of the countries that the gains from a customs union would be outweighed by possible losses associated with economic integration
- Fear of loss in sovereignty associated with the formation of a monetary union
- Response to economic shocks
- An evolving public/private economic growth mechanism

Incompatible Development Strategies

The first explanation stresses the fact that three of the key Gulf countries have been pursuing significantly different economic strategies. At one end of the spectrum, Saudi Arabia, by far the largest Gulf economy, has adopted an import substitution development strategy, i.e., the active encouragement by the government of selected industries capable of replacing imports and, hopefully, of one day developing competitive exports. To this end, the Saudi government has given numerous incentives to local producers. Not only have there been a wide range of subsidies available, but infant industries are entitled to up to 20 percent tariff protection on competing imports. Of the Gulf countries, Saudi Arabia is the only economy with a domestic market large enough for this strategy to make sense, albeit for a limited number of industries.

Because of its dwindling oil reserves, Bahrain's trade policy aims at eventually replacing 30 percent of its imports with domestic production. Here the government actively encourages local entrepreneurs to explore joint-venture arrangements with foreign investors to manufacture such products as plastic goods, tools, and pharmaceuticals.

At the other end of the spectrum, the UAE has historically followed a free trade policy; before 1994, tariffs on imports were minimal, at one percent, and even after 1994 the official tariff remained at four percent, much lower than most other GCC states.

In essence, cooperation over integration would entail Saudi Arabia agreeing to a significantly lower tariff for some of its key industries and/or the UAE agreeing to a higher rate of protection, thus hurting its re-export business to Saudi Arabia. The newly agreed 5 percent common tariff suggests that the Saudis are eager for integration to proceed and perhaps confident that their import-substituting industries are at the stage where less protection is required.

Possible Losses

While not much progress toward economic integration has been made to date, one still gathers that there has been a clear consensus of the member countries on the need for some cooperation or coordination to minimize the costs of economic change. One problem has been on deciding which integration path is optimal for the group as a whole. In this regard, there are two main forms of integration: a more general one, namely the customs union, and a more specific one, namely the joint-project approach to sectoral integration. Until recently, most activity had been of the joint-project type, with mostly lip service given to the custom union.

That a customs union has been hard to establish may be due to the fact that unlike the joint-project approach there could be some distinct costs borne by the member countries. In fact, in the short run it is not entirely clear that the countries as a group would achieve higher levels of income through the formation of a customs union. This stems from the fact that a customs union has both static (short-term) and dynamic (long-term) aspects. In the static sense, a customs union is beneficial if its trade creation (stimulation of trade between member states) effects exceed its trade diversion (shifting of trade away from low-cost non-member countries). Until recently, it was not at all clear that domestic industries could be competitive enough to tip the balance in favor of trade creation. Diverting trade from low-cost European, Japanese, or U.S. firms to high-cost, local producers most likely would have reduced the income of the countries a whole, as has been recently documented in a World Bank study of the Latin American trading area Mercosur (Yeates, 1998). Some recent evidence from the GCC countries (Hassan and Antoine-Mehanna, 2002) suggests that trade creation has predominated over trade diversion for the GCC group as a whole.

In the long term, a customs union could be justified if at least one of the following arguments holds:

- *The public good argument*. The development of an individual sector is assumed to have certain public good characteristics. It is regarded as essential, because health, education, and defense programs for the industrial sector indirectly contribute to economic development and the security of the country.
- *Economies of scale argument*. By forming a customs union, the enlarged internal market could be captured by the most efficient producer who could lower prices even further because of the economies of large-scale production. In the case of the GCC, the economies of scale argument is not sufficient to justify economic integration unless transport costs for foreign tariffs prohibit exports to the rest of the world. The GCC states could produce for domestic as well as world markets and thus reap economies of scale, such as Korea, Taiwan, and Singapore have been doing.
- *Terms of trade argument*. A country could improve its terms of trade by imposing a tariff on its imports (and tax on exports) if it accounts for a sufficiently large portion of world trade to influence world prices. Alternatively, it might use its economic power to obtain more favorable deals in the economic bargaining process. The terms of trade argument is also weak because the GCC states are unlikely to be able to influence the world prices of their imports on non-oil exports to any significant extent.

The only argument that could be made for the formation of a customs union-type GCC is the public good argument, though the other two could support it. Basically, this is the position taken by the GCC governments.

Loss of Sovereignty

Like a customs union, the creation of a monetary union entails potential costs and benefits. On the benefit side, the monetary union as currently conceived would no doubt result in a reduction in foreign exchange transaction costs, promote pricing transparency, and, consequently, increased competition. It would thus reinforce the positive aspects noted above that are associated with the customs union.

As with the customs union, these benefits come with a cost. Specifically, those costs are associated with the loss of national sovereignty stemming from the relinquishing of independent control over domestic monetary, fiscal, and exchange-rate policy. Here, the costs are of two types: first, the psychological cost of not having your own currency; and, second, a possible net loss in income due to the lack of ability to pursue expansionary monetary and fiscal policy during periods of falling oil prices. Of these, the second would seem to represent the most serious impediment to economic integration.

As we have seen in Europe, the formation of a GCC monetary union would involve somewhat arbitrary restrictions on national budgetary polices. Conceivably, this could significantly infringe on member countries' control over their individual taxation and public spending programs. The system would likely impose strict budgetary rules and constraints, because an excessive fiscal deficit in one individual member country could undermine exchange rate stability throughout the whole currency area. Saudi Arabia, for instance, might find that it could not expand expenditures during a recession to the extent it might prefer, because of the adverse effect it might have on, say, Bahrain and Oman.

In short, as the EU countries have found, a common currency requires fairly close economic similarities among the member countries. This uniformity does not really exist in the GCC. The question here is are the differences between Saudi Arabia and, say, Bahrain so great that a common set of macro-economic constraints on both countries might not be in their economic interests?

Economic Shocks

International economic shocks have had a contradictory effect on the Gulf integration process. "Although external economic pressures have likely provided a crucial impetus for cooperation, until recently, downturns have also hardened the members' reluctance to forfeit control over national economic and trade policy" (Cammett, 1999). Typically, during these periods, economic reforms and liberalization are put on hold as the governments attempt to preserve domestic jobs.

Evolving Public-Private Economic Mechanism

Related to the external shock factor, the authorities in the GCC countries have usually been reluctant during periods of declining oil prices and revenues to cut spending, because of their concerns regarding the potential adverse effects on non-oil growth. However, when confronted with the need to cut spending, in periods of declining oil revenues, they have often chosen to reduce first capital over current expenditures. An IMF study examined these patterns to determine whether there was any empirical evidence on the effectiveness of these expenditure patterns in stabilizing the economy (Fasano and Wang, 2001). The main, somewhat counterintuitive finding was the lack of a strong causal relationship running from government spending to non-oil growth. Put differently, the governments in GCC countries could in principle cut spending without negatively affecting non-oil growth.

No doubt this new public sector expenditure/private output relationship reflects structural changes that have been taking place in the GCC economies over the last several decades. In particular, it reflects the success that many of these countries have had in diversifying their economies. A manifestation of this success has been the observed weakened structural dependence of non-oil activities on government spending in such countries as Saudi Arabia (Looney, 2001).

These recent findings on the weakening links between government expenditure and non-oil output/private sector activity fundamentally change the way one looks at the growth prospects for the GCC countries. They also have significant implications for the integration process. Several years ago, the received conventional wisdom was that the non-oil economy simply mirrored the government's fiscal policy, which in turn was supported by oil revenues and increased governmental debt.

Following this logic, the conventional wisdom for development in the post oil-boom years was quite pessimistic. Here, the focus was usually on budgetary cutbacks, the seeming inability of the government to push through economic reforms, increased public sector debt, the drying up of credit to the private sector, capital outflow, and declining rates of private sector capital formation. The conventional wisdom usually concluded that whatever growth occurred was ultimately tied in with dwindling government expenditures. Meager rates of non-oil private output simply reflected the limits on governmental expenditures. In short, the assumption was that loss of governmental borrowing capacity and the associated fiscal expenditures would result in a quick collapse of the non-oil economy.

Future Prospects

The shift over time from strong to weak or non-existent links between government expenditures and non-oil private sector activity in the Gulf countries no doubt goes a long way in explaining governmental attitudes toward economic integration in the region. Initially, government expenditures were viewed as indispensable in sustaining economic activity and employment. The costs of losing discretionary power over fiscal policy were viewed as extremely high, with the benefits of integration somewhat problematic. In recent years, the realization seems to have set in that the old fiscal tools have lost much of their stimulus power (Dasgupta, Keller and Srinivasan, 2002) and the cost of their loss or restriction imposed by a customs or monetary union much less severe. At the same time, the increased viability of the private sector seems to have progressed to the point where it is capable of taking advantage of most of the opportunities opened up by the creation of a customs and/or monetary union.

In short, the tide of pluses and minuses associated with the formation of a customs/monetary union has shifted to the plus side. At the present time, a customs union would give the Gulf States greater leverage to attract foreign investors and accelerate economic reforms in the region to diversify and further stimulate their economies away from oil revenues. An added impetus for the formation of a customs union has come from the European Community (EC). As part of its policy to encourage the formation of regional trade blocks in the developing world, the EC has urged the Gulf States to implement a unified external tariff, making a comprehensive trade agreement with the Gulf States contingent on this action.

The losses associated with integration, while still present, are unlikely to offset these benefits. If this interpretation is correct, the push for economic union should be strong enough to overcome any remaining impediments.

For Further Reading

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